

<b>Criterion #3: Equitable Division of Property, Funds and Obligations</b>
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**State Criteria:** The proposed reorganization will result in an equitable division of property and facilities, including debt and monies due and not collected, of the original district (ref. Education Code Section 35753 (a)(3)). The Education Code (EC) provides standards for the division when the allocation is not fixed by terms, conditions, or recommendations (ref. EC 35560 Section) and allows for alternative methods if the proposed division is included in plans and recommendations that are an integral part of the proposal (ref. EC Section 35736). The division of student funds is addressed in EC Section 35564.

Title 5, California Code of Regulations, Section 18573(a)(3)) explains the role of the California Department of Education, is “to determine whether an equitable division of property and facilities will occur, the California Department of Education reviews the proposal for compliance with the provisions of Education Code Sections 35560 and 35564 and determines which of the criteria authorized in Section 35736 shall be applied. The California Department of Education also ascertains that the affected districts and county office of education are prepared to appoint the committee described in Section 35565 to settle disputes arising from such division of property.”

The requirements of each of these provisions of law and the potential application on the Southeast Area proposal are discussed more fully in the analysis that follows.

**Analysis:** An equitable division of the LAUSD’s property, funds and obligations is an essential part of any proposed reorganization, so that:

- 1) the new district receives available resources and obligations associated with serving the pupils in the Southeast Area; and,
- 2) the remaining LAUSD is not unduly harmed fiscally as a result of the reorganization.

In other words, the newly unified district would require its share of the original district’s net assets in order to meet the educational needs of the pupils with no or minimal disruption to the educational program.

The Education Code allows for a choice in the manner under which the division of property, funds and obligations are made.

Under EC Section 35560, “when the allocation is not fixed by terms, conditions or recommendations as provided by law”, the method of allocation (excluding bonded indebtedness, addressed elsewhere in the law) is as follows:

- a) “The real property and personal property and fixtures normally situated thereat shall be the property of the district in which the real property is located.
- b) All other property, funds, and obligations, except bonded indebtedness, shall be provided pro rata among districts in which the territory of the former district is included. The basis for the division and allocation shall be assessed valuation of the part of the former district that is included within each of the districts.”

Under EC Section 35736, the districts may consider alternative methods, including: “the assessed valuation of each portion of the district (similar to EC Section 35560), the revenue limit per pupil in each district, the number of children of school age residing in each portion of the district, the value and location of the school property, and such other matters as may be deemed pertinent and equitable. Any such proposal shall be an integral part of the proposal and not a separate proposition.”

The methods that are used can produce significantly different results, and even though provided for in law, may not be equitable. For example, the proportionate enrollment (or ADA equivalent) and proportionate assessed valuation in the Southeast Area are two widely differing amounts that, if applied to an asset or liability would yield very differing results.

Area	# Estimated Pupils*	Pro Rata Enrollment	Assessed Valuation** (in Thousands)	Pro Rata Assessed Valuation
Southeast Area				
Unified District	67,700	9.4%	\$ 9,322,458	3.92%
LAUSD	655,000	90.6%	\$228,521,434	96.08%
LAUSD Totals, Before Reorganization	722,700	100%	\$237,843,892	100%

\*Source: LAUSD, based on 2000 CBEDS, this amount approximates the pro-rata ADA

\*\* Source: Los Angeles Auditor-Controller's Office

Therefore, if all property (except real property), funds and obligations were divided based on assessed valuation (as provided under EC Section 35560), the Southeast Area, with its relatively low assessed valuation, would receive proportionately less funding than the pupils it would be required to serve. ADA is probably a better allocation method for certain categories of funds and

obligations since nearly all operating funds are allocated on a per ADA or enrollment basis by the state and federal governments.

The actual intended terms and conditions for the division of property, funds and obligations is best spelled out early on in a proposal by the petitioners, recognizing that county and state level reviews may amend the terms and conditions and ultimately the allocation may be arbitrated (see Disputes Over the Division of Property, Funds and Obligations discussed later in this section).

However, for feasibility study purposes NNW has endeavored to conduct an analysis of LAUSD's property, funds and obligations as of June 30, 2000 (using the audited financial statements of the District) and then apply a series of allocation assumptions. The purpose of the analysis is to evaluate whether or not an equitable division might result and whether either affected district might be fiscally harmed by the process – this concern relates to Criterion #9, Fiscal Management and Status and ultimately to Criterion #6, Educational Program. The actual results will vary from this analysis due to the timing and outcome of the negotiations.

### **Fund Balance Reserves**

In general, all fund balance reserves are subject to division. An exception, for example, might be when the reserve is designated for debt service on an obligation that is not divided, such as an outstanding loan on property outside the reorganization area. In effect, the asset should follow the liability. An equitable method for allocating fund balance reserves is usually dependent on how the revenues are generated within the fund, e.g. ADA/enrollment, assessed valuation, or number of full-time equivalent employees.

Division of LAUSD's fund balance reserves could reasonably and simply be based on pro rata average daily attendance (ADA) and assessed valuation (AV), as shown:

<b>Fund Balance Reserve</b>	<b>Total LAUSD Reserve (In Thousands)</b>	<b>Allocation Assumption</b>	<b>Est. Allocation to a Southeast Area District (In Thousands)</b>
General Fund	\$606,510	9.4% (ADA)	\$57,012
Special Revenue Funds	\$157,355	9.4% (ADA)	\$14,791
Debt Service Funds	\$81,746	3.9% (AV)	\$3,188
Capital Project Funds	\$810,891	3.9% (AV)	\$31,625
Internal Service Funds	\$18,438	9.4% (ADA)	\$1,733
Non-Expendable Trust Funds	\$17,774	9.4% (ADA)	\$1,671
<b>Total</b>			<b>\$110,020</b>

Source: LAUSD's June 30, 2000 Audited Financial Statements

The negotiating parties might devise alternative or more precise allocation methods. For example, upon closer inspection of each fund:

- The Adult Education Fund could be divided by pro rata adult education ADA.
- The Child Development Fund divided by program enrollment.
- The Deferred Maintenance Fund divided by project area.
- The FEMA – Earthquake Fund divided by project area.
- The Debt Service Funds in the same manner as the associated debt (e.g. AV for bonded indebtedness, ADA for certificates of participation or project location).
- The Capital Facilities Funds may be divisible by project location or other methods as might be equitable given the purpose of the fund.
- The Internal Service Funds (i.e. health and welfare, worker's compensation and liability) might be divisible by FTE, but might also be approximated by ADA.
- The Non-Expendable Trust Funds (i.e. retiree health and certificated attendance incentive rewards fund) might be divisible by certificated FTE, but might also be approximated by ADA.

In sum, there are a variety of alternative methods to divide fund balance reserves that could yield an equitable division, including the most often-used methods of ADA and assessed valuation.

### **Real Property and Fixtures Normally Located on the Property**

Education Code Section 35560 provides that real property and the furniture and equipment normally located on the property will be transferred to the district in which it is located. This would include all of the Southeast Area facilities listed in Appendix D-3.

In addition, the facilities, equipment, furniture and buses at LAUSD's administrative offices and business facilities are subject to division. This is noteworthy since few administrative offices and alternative education sites are located in the Southeast Area (please refer to LAUSD Facilities, listed under Criterion #7, School Housing Costs). Because the division of facilities does not appear to be equitable, a new Southeast Area district might argue for adequate compensation based on the loss of equitable facilities. These negotiations may result in the transfer to the new district of ownership for equipment, furniture, buses or other assets. This process may involve appraisals, especially for the real property. The net book value of equipment, furniture, buses and other assets might be an appropriate valuation for allocation purposes.

### **Student Body Property, Funds, and Obligations**

Education Code Section 35564 specifies that the county committee on school district organization determines the manner in which student property, funds and obligations are allocated between the reorganized districts, with the stipulation that the amounts allocated not exceed the ratio which the number of pupils leaving a school bears to the total number of pupils enrolled. In addition, funds that are bequests or gifts to an organized student body of a school remain the property of that school's student body and are not divisible.

The student population of each of the Southeast Area study schools would remain substantially intact. Thus, all student funds would remain at the schools with the following exceptions. There may be some pupils attending outside the Southeast Area that, upon unification, would leave LAUSD to attend school in the Southeast. These pupils may be allocated proportionate student funds to the number of pupils leaving each effected school. The reverse would also be true if there were students attending school within the Southeast Area that resided outside the study area and returned to the remaining LAUSD. Currently, there are more Southeast Area students on intra-district attendance agreement than there are pupils coming into the area.

### **Long-Term Debt**

LAUSD has general obligation bonded indebtedness, compensated absences (e.g. accrued vacation), Certificates of Participation (COPs) and capital leases, and State School Building Loans. The following discusses the intricacies of equitably dividing debt between LAUSD and a Southeast Area district. The discussion is also somewhat hypothetical as: (1) there is no current proposal to unify the Southeast Area; (2) the actual amounts to be divided will be based on the year prior to the effective date of the unification (some future point in time) and not the year used in this analysis; (3) the results of negotiations, legal interpretations and possible arbitration will all play into the final allocations. However, the net result provides some insight into the issues related to the division of the debt and the potential impact on the affected districts.

Outstanding General Obligation Bonds: Education Code (EC) Section 35576 governs the division of bonded indebtedness when territory is transferred from one district to the next (e.g. LAUSD to the Southeast Area) and "the area transferred contains public school buildings or property..." This law is applicable to the Southeast study area since a newly unified district would acquire approximately 40 facilities and LAUSD has outstanding bonded indebtedness.

The law first provides, under EC Section 35576(a), that the new district acquiring the property drops its share of bonded indebtedness from the former district. However, in EC Section 35576(b): "The acquiring district shall pay the original district the greatest of the amounts determined under provisions of paragraphs

(1) or (2) or the amount determined pursuant to a method prescribed under Section 35738.” In other words, the newly unified district that is acquiring property must compensate the original district in one of two methods specified within the law. Those two methods are:

1. EC Section 35576(b)(1) and 35576(b)(2) requires compensation at the greater of: (1) the proportional share of assessed valuation; or, (2) the outstanding bonded indebtedness, which was incurred for the acquisition or improvement of school properties in the territory.
2. EC Section 35738: The reorganization proposal may include other methods for the division of bonded indebtedness “for the purpose of providing greater equity in the division.”

Whichever method is used, “county board of supervisors shall compute for the reorganized district an annual tax rate for bond interest and redemption which will include the bond interest and redemption on the outstanding bonded indebtedness specified...” This means tax will be collected from property owners in the Southeast Area at either the same rate collected today (i.e. for LAUSD’s bonded indebtedness) or at a higher or lower rate depending on which method is deemed most equitable. The following analyzes which method might be most equitable and whether or not the method would mean more, less or the same tax rate to the property owners in the Southeast Area.

LAUSD has a considerable amount of new construction budgeted for District J (see Criterion #7, School Housing Costs). The projects, totaling \$311.5 million, appear to be part of the District’s master plan and to be budgeted primarily out of Proposition BB funds. All of the projects are scheduled for completion between years 2002 and 2005. If these projects come to fruition prior to a unification of the Southeast Area, the amount of outstanding bonded indebtedness that is incurred for the acquisition or improvement of school properties would likely exceed proportional assessed valuation, as shown:

	<b>Total Outstanding Balance at June 30, 2000 (In Thousands)</b>	<b>Est. Allocation to the Southeast: Based on Proportionate AV (3.9%)</b>	<b>Est. Allocation to Southeast: Acquisition Debt (In Thousands)</b>
General Obligation Bonds, Issued	\$982,460	\$38,316	—
General Obligation Bonds, Authorized But Unsold	\$1,394,000	\$54,366	—
<b>Total Potential Bonded Indebtedness</b>	<b>\$2,376,460</b>	<b>\$92,682</b>	<b>\$311, 500</b>

Source: LAUSD’s June 30, 2000 Audited Financial Statements.

From a taxpayer's perspective, if bonded indebtedness is indeed divided based on the fact that acquisition debt is greater than debt that is proportionate to assessed valuation this is problematic. As computed under Criterion #7, School Housing Cost, the tax rate levied per \$100,000 in assessed valuation could increase by 230% -- making division of the debt a hardship on the property owners in the Southeast Area.

Legal minds might argue that application of EC Section 35576 is not equitable and other rationales should apply -- namely EC Section 35738. The argument might be supportable if LAUSD has invested more in school housing in other areas of the District to the detriment of the Southeast Area and are only today addressing the Southeast facilities needs. This view was expressed by some members of SECEDE. Any other outcome, other than the prescribed methodology of EC Section 35576, however is speculative.

Authorized But Unsold Bonds: Education Code Section 35577 provides that authorized but unsold bonds be divided based on proportionate assessed valuation. LAUSD has approximately \$1.4 billion in authorized but unsold bonds, as of June 30, 2000. However, all of the funds have been budgeted and it is anticipated the entire bond issue will be sold before unification of the Southeast Area, assuming a petition is circulated for signatures.

Certificates of Participation (COPs) and Capital Leases: This form of debt is subject to equitable division and proportionate ADA is usually an appropriate divisor. LAUSD's debt service fund, called the Capital Services Fund, makes the annual lease payments through General Fund operating transfers coupled with investment income. However, it appears that most if not all of the projects in which COPs were issued were projects outside of the Southeast Area -- projects that will not transfer upon unification, see Appendix D-5. Therefore, it might be equitable to divide the COPs based on the location of the projects or the location from which expenditures from the COP proceeds were made.

Not allocating the COP debt would create some financial hardship for LAUSD. The total debt service on COPs, in 1999-2000, was \$18,840,000 and if not allocated would be borne entirely by the remaining district -- an added financial outlay of \$1.8 million (i.e. 9.4% of \$18,840,000). However, from an auditor's materiality perspective the amount would not be considered material (for a General Fund budget of over \$5 billion, approximately \$90 million would be considered material). And, LAUSD would retain ownership of the assets.

Other Debt: In addition to the large amounts of bonded indebtedness and COPs, LAUSD is paying off State School Building Loans and has compensated absence liabilities. These debts would like be divided by assessed valuation and ADA (or FTEs), respectively.

### Summary of the Estimated Division of Debt

The following table summarizes a possible outcome from the division of debt process. Note that the Southeast Area might assume 11.7% of the debt as compared to only 9.4% of the ADA and 3.9% of the assessed valuation. But, keep in mind that the division of debt (and assets) is a negotiated, and often arbitrated, process.

<b>Description</b>	<b>Total Outstanding Balance at June 30, 2000 (In Thousands)</b>	<b>Basis for Allocation</b>	<b>Est. Allocation to the Southeast (In Thousands)</b>	<b>Southeast Area's Percentage of Debt Acquired from LAUSD</b>
General Obligation Bonds* Issued	\$2,376,460	EC Section 35576	\$311,500	13.1%
State School Building Aid	\$3,572	Assessed Valuation	\$139	3.9%
Capital Leases and Certificates of Participation	\$259,427	Location of Projects	\$0	0%
Compensated Absences	\$67,722	ADA (or FTE)	\$6,366	9.4%
<b>Total*</b>	<b>\$2,707,181</b>		<b>\$318,005</b>	<b>11.7%</b>

*\*Includes authorized but unsold Proposition BB bonds.*

### Disputes Over the Division of Property, Funds and Obligations

If a dispute arises in the course of negotiations over an equitable division of property, funds and obligations, then Education Code Section 35565 outlines an arbitration process that involves the affected school districts and the county superintendent of schools working through a board of arbitrators. The board is composed of one member selected by each district and the county superintendent of schools. If mutually agreed-upon, the county superintendent could act as sole arbitrator, but generally the entire board is involved. The arbitration process results in a written report and findings that are final and binding on each party.

Because there appears to exist a lack of equity in the number (and probably value) of the properties to be transferred from LAUSD to a newly unified Southeast Area district, it is likely that other means of compensating the newly unified school district might be needed. Determining an equitable level of



compensation and the type of compensation (e.g. cash, other tangible property, long-term notes payable, other offsetting assets or debt relief) would likely require the work of a board of arbitrators. The newly unified district should be aware that such processes are often lengthy and legal costs will be incurred.

### **Summary**

It is feasible that a Southeast Area district would share in fund balance reserves, if unified today, of approximately \$110 million and acquire \$318 million in long-term debt. Of the \$318 million in long-term debt, approximately \$311.5 million would be bonded indebtedness and \$6.5 million would be funded with operating revenue (primarily for compensated absences – a normal business expense).

In the end, a Southeast School District would not appear to be burdened operationally but unless negotiated otherwise, the bonded indebtedness that would be allocated may be too high a burden for the taxpayers of the Southeast Area. Nevertheless, it still appears feasible for an equitable division of property, funds and obligations to occur.

**Consultant's Conclusion:** Based on the data provided by LAUSD and NNW's analysis, the proposed unification of the Southeast Area appears to result in an equitable division of property, funds and obligations and the criterion appears to be met.

*Feasibility Study of Removing the Schools in the Southeast Area  
of Los Angeles Unified School District from the School District*

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